

Bank of Canada preview: Why the BoC could open the door to a June rate cut

Inflation is converging on target and labour market slack is increasing, but for now, Canada's central bank remains wary. Nonetheless, it doesn't want to cause a recession and we expect the BoC to open the door to a possible June rate cut. We expect CAD to underperform other commodity currencies



Opening the door to a possible June rate cut, Bank of Canada Governor Tiff Macklem

Economic backdrop encourages further dovish shifts

The Bank of Canada is widely expected to leave the policy rate unchanged at 5% next week, with the market (at the time of writing) only pricing about 4bp of easing – roughly equivalent to a 15% chance of a 25bp rate cut. Since the 6 March policy meeting, the economy has recorded strong jobs numbers and a larger than expected 0.6%MoM increase in GDP for January. But at the same time, inflation has surprised to the downside and the unemployment rate has actually increased as the labour force expands through high rates of immigration. As for sales, the BoC's business survey reports the outlook remains "subdued".

We expect the BoC to maintain its policy stance, with BoC Governor Tiff Macklem likely to repeat that that *"future progress on inflation is expected to be gradual and uneven"*. That said, we do

expect them to open the door to a possible move in June. The strength in January GDP was aided by the end of a public sector strike in Quebec and milder weather. The prospects for second-quarter activity are not looking as strong, while headline inflation is now within the BoC's 1-3% target range, and core inflation could be there next month.

The effects of previous rate hikes are still feeding through since Canadian mortgage rates continue to ratchet higher for an increasing number of borrowers as their mortgage rates reset after their fixed period ends. This will intensify the financial pressure on households, dampening both consumer spending and inflation. Unemployment is also expected to rise further as the population expands more rapidly than job creation, which will cap wage gains.

Monetary policy is restrictive, and the BoC doesn't want to cause a recession if it can avoid it. If there's confidence that inflation is indeed converging on its target and labour market slack is increasing, then we think the BoC will cut rates in June.

Market impact: CAD to lag other commodity currencies

Currently, the market is pricing 18bp of easing by the 5 June policy meeting – equivalent to a 72% chance of a 25bp rate cut – and a total of 75bp of easing by the end of the year. The risks appear skewed to the downside for short-term rates as the more encouraging inflation outlook may prompt more BoC cuts than expected.

From a market-reaction perspective, this April meeting could see some tentative decoupling of BoC and Fed rate expectations. That depends not only on the BoC delivering a dovish message and opening the door for a June cut but also on US data meeting expectations. BoC rate expectations have been strictly tied to Fed ones and are often insensitive to Canadian data and the BoC communication.

In a scenario where US data gradually weakens and the BoC sounds more dovish than the Fed before the 1 May FOMC meeting, the Canadian dollar should emerge as an underperformer in the G10 space. We expect this CAD weakness to manifest clearly against other high-beta commodity currencies such as NOK and AUD, while USD/CAD may stabilise in the 1.35/1.36 range in the near term before a clearer-cut USD decline emerges.

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an

investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.